NOTES

WASHINGTON NOTES

GOVERNMENT CONTROL OF RAILROADS

Probably the most far-reaching action with reference to transportation taken by public authority in a generation or more has been the President's proclamation on December 26, directing the practical transfer of the railroads of the country to government control. The course thus determined upon follows the publication of the findings of the Interstate Commerce Commission on December 5, wherein it is set forth, in reply to the roads' plea for higher rates, that such higher rates would not materially assist their present condition. From the standpoint of the government three principal reasons are seen for the taking over of the lines:

1. The avoidance of obstructions to transportation due to the routing and division of freight, intended to give a fair share to each line in a given territory.

2. The abolition of preferences to given shippers and kinds of freight, and the centralization of control over priority in shipment.

3. The practical termination of rate controversies and labor discussions as between private individuals and the placing of the roads on a semi-military basis.

The railroads themselves have received the announcement of the President's action with much greater equanimity than could have been expected. They undoubtedly see in the step the following advantages:

1. Assurance of a moderate if not generous income in a period of great uncertainty and difficulty, during which they have been caught between the upper and nether millstones of fixed rates and advancing costs and wages.

2. Termination of the danger that threatened them from the continually maturing obligations which ordinarily they would have little trouble in refinancing, but which, under existing conditions, can scarcely be provided for on any basis.

3. Provision of means for betterment and improvement at a time when such provision can be had practically only through government

orders designed to place such requirements ahead of those of private concerns.

Due to recognition of these considerations, investors who had previously regarded the situation with the utmost pessimism have shown much greater confidence and enthusiasm with respect to railroad securities, as indicated by a rise of from five to ten points in general values.

By retaining the railroads' own organization and enlisting the service of men familiar with transportation conditions the new experiment may prove to have its advantages over the old situation—at least as a war measure. The interesting phase of the conditions thus produced is, however, found in the question whether what is successful as a war expedient will or will not be continued during times of peace; in other words, whether this experiment in public control may develop into a policy of permanent public ownership with all of the problems entailed by such a change. There is already suggestion of the difficulties likely to be entailed by such a new policy in the prediction that the President's plan to compensate the roads on the basis of their average net earnings for the past three years will be sharply opposed in Congress. So many serious economic and political problems are raised by the proposed policy that some months will be required for the development of even a tentative judgment as to the wisdom of the new step from any standpoint except that of war emergency. One of the many points upon which valuable information will be furnished by the new experiment will be the much-contested question whether or not savings in operating costs can be effected under government control by the elimination of competitive wastes, so called, the avoidance of duplication in auditing and accounting, and the improved management of financing and purchasing which, it has already been asserted, can be had through joint or central control.

EARNINGS OF FEDERAL RESERVE BANKS

One of the interesting features of the banking history of the year 1917 is proving to be the development of the earnings of the federal reserve system. It was predicted that when the Federal Reserve act was passed the banks would be unable to pay expenses, to say nothing of "making money." This idea continued to be entertained by not a few during the first two years of the life of the system, and so strongly was the opinion entertained that it resulted in proposals here and there to reduce the capital of federal reserve banks by 50 per cent or, according to the suggestions of some, to a merely nominal figure. Experience during the year

1917 has put these notions to rout by showing the capacity of the federal reserve system as an income earner. Although reserves at the close of the year are well over 60 per cent, and during much of the period between 80 and 90 per cent, of liabilities, the expansion of business at the federal reserve banks due to government financing has enabled almost all of the banks to cover arrears in their accumulated dividends and to open the year 1918 with a very substantial surplus in addition. This has been done after the adoption of a liberal depreciation policy in which the Federal Reserve Board has laid down only the following restrictions:

1. That federal reserve banks should be permitted to charge off furniture and fixtures account in full and not exceeding 10 per cent of the cost of vaults.

2. That no charge be made against the cost of federal reserve notes except the notes actually issued to the bank by the federal reserve agent.

3. That on the cost of bank premises depreciation allowance in any one year should be limited to 5 per cent of the total cost.

No reserve for depreciation against 3 per cent one-year notes has been provided, as these notes may be taken up on any interest date.

In addition to covering their book earnings and making provision for depreciation, the federal reserve banks are paying to the government a sum likely to amount to near one million dollars, while a similar amount under the terms of the law is transferred to surplus account, upon which, in the event of liquidation of any bank, the government has a contingent claim. Even those federal reserve banks which have not declared dividends fully covering their arrears might have done so had it not been for the adherence to a conservative policy, recognizing the possibilities of loss, and hence requiring the maintenance of a moderate balance of earnings.

This is an extremely creditable record and promises well for the future of federal reserve banks as income earners should their present volume of business be maintained. The interesting theoretical question in this connection is the probable extension of their volume of business in the event of a declaration of peace. Would the banks in such a case be allowed to return to their former condition of comparative inactivity? They have shown that they can make large earnings at the same time that they maintain high reserves and yet fully protect the community. The question of their continuing to do so is primarily the underlying basic question of the relation of the federal reserve system to the banks

of the country as a whole. If it be desired to have them active participants in the discount market, like the great European banks, they could undoubtedly occupy that place and continue to make large earnings. The return of peace, which will bring with it so many great economic questions, will undoubtedly include among them this one—the position to be occupied by the federal reserve banks in the financial market of the future; and the answer given to it will itself afford the answer to many incidental and dependent questions.

DISCOUNT RATES

Intimately associated with the progress of government financing and the condition of the banks of the country as a whole has been the discount rate situation at federal reserve banks. Since the first adjustment of discount rates effected shortly after the organization of the system, changes called for by circumstances have been comparatively unimportant, the most significant being found in the establishment from time to time of new rates for special classes of paper. At the beginning of the year 1917 banking conditions the country over were strong and discount rates generally low. It was expected by some that the entry of the United States into the war would bring about an almost immediate advance in rates of interest, but this tendency developed much more slowly than had been expected. There was therefore but little necessity for change in the rates of federal reserve institutions until the placing of the first Liberty Loan was well under way.

At the time of the first loan, in order to facilitate the operation of disposing of the bonds the Board thought best to recommend to federal reserve banks the establishment of uniform preferential rates in favor of paper protected by government obligations. With these, as with the ordinary offerings of eligible commercial paper, a distinction was made between short-time obligations and those of a longer period. Accordingly member banks' collateral notes running fifteen days protected by government obligations were generally placed upon a 3 per cent basis, while ninety-day obligations collateraled in the same way were given a $3\frac{1}{2}$ per cent rate, these figures being about one-half of 1 per cent below the rates fixed for paper of similar maturities protected by ordinary commercial paper. Owing to the co-operative and generous action of the banks throughout the country in undertaking to advance funds to borrowers who desired to purchase government bonds at rates of interest corresponding with those borne by the new obligations and consequently involving no profit to themselves, these rates give to the borrowers of

the country the full advantage of access to federal reserve banks for the purpose of carrying their loans necessitated in the purchase of such securities. The satisfactory working of the policy in facilitating the movement of the bonds into the hands of their ultimate holders has been sufficiently reviewed in another issue of the *Journal*. Increases in commercial rates of discount began to make themselves apparent during the late summer at most of the financial centers throughout the country, and the raising of the rate of interest borne by the second Liberty Loan to 4 per cent as against the $3\frac{1}{2}$ per cent on the first issue of bonds suggested the propriety of a general advance of one-half of 1 per cent in federal reserve rediscount rates. Such an advance was accordingly suggested to the banks and generally put into effect at the close of November and during the first two weeks of December, the differential in favor of government-secured paper being, however, still maintained. Incidental to this revision of rates it was also thought best to merge with the ordinary commercial rates the special rate previously made upon paper secured by warehouse receipts and designated by the Board as "commodity paper." This rate, originally made for the purpose of assisting in the movement of the crops and the rendering possible the regular marketing of reserve supplies in such a way as to avoid sudden inflations of prices, had been rendered unnecessary by the great advance in commodity prices and by the change in conditions which rendered it preferable that supplies should move steadily to market rather than they should be held in storage by producers or middlemen. These changes in discount rates, moreover, have been followed and accompanied by a resort (for the first time) to the use of the inter-reserve bank rediscount function. Those banks which during December were heavily drawn upon by customers during the government financing were enabled to transfer some paper with their indorsement to other reserve banks, thus equalizing the resources of the country.

RESERVE BRANCHES

One of the most important duties devolving upon the Federal Reserve Board during the year 1917 has been the better working out of the policy of the federal reserve system with respect to branch offices of federal reserve banks. Section 3 of the Federal Reserve act, relating to branches, in its original form presented some ambiguities which the Board was able to adjust only tentatively. Perhaps the most serious source of uncertainty lay in the apparently mandatory requirement of the law that federal reserve banks should establish branch offices, the

Board's power and responsibility in the matter being thus apparently the subject of some uncertainty. Differences of opinion with reference to the establishment of such branches almost unavoidably existed in certain of the districts, and Congress therefore wisely, by the act of June 21, transferred to the Federal Reserve Board the power to decide whether branches should or should not be established in any given case, while it left to the Board a large measure of authority as to the organization and characteristics of the branch thus to be established. Prior to the adoption of this amendatory law the Board had already devoted much attention to the needs of the several districts in this respect and had reached the conclusion that, while it was desirable in every case that newly established branches should be created only where there was reason to believe that they would be self-supporting and active institutions, there was also to be taken into account the general question of broad public policy affecting the convenience of the member banks and of the public in respect to their access to the offices of the federal reserve system. Acting upon this conviction and after consultation with the local bankers affected in each case, the Board during the year 1917 provided for the establishment of branch offices at Pittsburgh and Cincinnati in district No. 4, at Baltimore in district No. 5, at Detroit in district No. 7, at Louisville in district No. 8, at Omaha and Denver in district No. 10, and at Seattle, Portland, and Spokane in district No. 12. There had previously been established in 1915 a branch of the federal reserve bank of Atlanta in district No. 6 at New Orleans. In the New Orleans branch, the first to be established, a theoretical segregation of the capital of the parent bank and the assignment of a separate territory had been effected. Experience has shown that this plan was open to some objection, and in creating the new branches established under the authority of the act of June 21 the Board has consequently developed a new type of organization. Under the new plan it is intended that the branch shall be a local office of the parent institution, member banks having the option of dealing direct with it or with the parent as they may see fit. They may transmit their items for collection to the branch office or to the parent as they see fit, and they may elect whether to present their discount offerings at the branch or at the head, giving due notice of their choice subject to later revocation at their pleasure. Bookkeeping and accounting operations are thus conducted at the head office, which reports direct to the Board, and the relations between the Board and the branches are thus reduced to a minimum so far as the daily routine of administration is concerned. The management of the

branches has been placed in the hands of a board of five directors, three of whom are selected by the parent institution, while two are designated by the Board. One of the three directors chosen by the federal reserve bank is named by it as manager of the branch. Time has not yet been sufficient to test this plan of organization, but the Board believes that with such modifications as experience may prove to be necessary this will become the standard type of branch office and that those branches organized under the earlier plan will be converted into the new form. From the beginning of the year 1918 the system will consist of the twelve parent institutions and the eleven branches already provided for. At the present moment no other or additional branch offices appear to be required.